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NEBRASKA BANK FAILURES AND THE STATE OF NEBRASKA BANKING

THE PRESENT

On Thursday, March 6, 1986, the First National Bank of Tekamah was closed by the Federal Deposit Insurance Corporation. It was the twenty-second Nebraska bank to have services suspended since the Bank of Niobrara was shut down on July 8, 1983. In contrast, the Bank of Niobrara was the first Nebraska bank to fail since the Elm Creek State Bank in April 1973. Only five Nebraska banks had failed or had closed voluntarily in the twenty-three years from 1960 through 1982.[1]

These twenty-two failed banks had many similarities:

1. They were located in communities of less than 6500 inhabitants, with the average population around 1500. Smaller banks tend to be the most vulnerable to failure[2] due to partial deregulation, which has exposed small town bankers to a wide range of new competition. They are more vulnerable, also, because of the narrow economic base of the community.

2. These banks were, for the most part, farm banks, defined as those institutions with at least 25 percent of their loans in agriculture. For example, the State Security Bank of Broken Bow, which closed December 5, 1985, had 58 percent of its $4.4 million loan portfolio in agriculture-related loans.[3] This inability on the part of small town bankers to diversify from farm loans doomed many banks when the farm economy faltered.

3. All but one of the twenty-two banks were state chartered institutions; the First National Bank of Tekamah was the exception. In Nebraska, there are about 335 state chartered banks (regulated by the state) and about 122 nationally chartered banks (regulated by the U.S. Comptroller of the Currency). The state has more discretion in closing a troubled bank than the U.S. Comptroller of the Currency.[4]

4. All but one of the failures involved the FDIC in the closing and transfer of funds. The Blair bank was taken over and then reopened as a branch of the Omaha National Bank without FDIC involvement.

5. Six of the twenty-two failed banks never reopened. The FDIC was unable to find solvent banks willing to enter those markets, either because the towns were too sparsely populated (as in the case of Dannebrog, Oak, or Elba) or because the presence of other financial institutions created an saturated market (as in Broken Bow). In cases where the FDIC has been unable to attract buyers, the lack of interest is reflected in the weak agricultural economy as well as the size and location of the town. If the town is not a county seat and not on a major highway, it can have problems attracting potential buyers.[5]

6. A number of failed Nebraska banks were part of a chain of banks owned and operated by an individual or partnership with individual banks in the chain maintaining their own identity. The distinction between chain banks and branch banks is subtle.

There is presently no stated limit to the number of banks an individual or partnership can own in a chain, though the state does maintain limits on the extent of branching and bank holding company expansion.[6] For example, the four Nebraska banks closed on May 31, 1985 were, or had been, part of a single chain, as were the three Nebraska banks closed on December 18, 1985.

With weakened chain banks, multiple bank failures can occur at the same time. On the other hand, if a multi-branch bank fails, it is considered only one failure. One problem with chain banks is that a single individual or family can control an unlimited number of banks, leading to an absentee ownership situation. For example, Roger Beverage, former State Banking Director, attributed the failure of the Bank of Verdigre on September 19, 1984 to the bank's absentee ownership, as well as bad farm loans.[7]

7. Above all, the common denominators in most of the twenty-two Nebraska bank failures are liberal lending practices, especially during the 1970s, coupled with the deteriorating agricultural situation. Historically, loans were granted on the basis of the three C's: character, collateral, capacity (ability to repay).

Too many banks relied upon collateral alone.[8] In the event of a loan default, the bank could sell the collateral in the form of land, which presumably would have held its value or appreciated. Farm land values, however, declined by 50 percent or more between 1981 and 1986 due to the diminished cash flow potential of the land, the decline in export prospects, and the decrease in the demand for land by foreigners who had purchased land in the 1970s as a safe-haven.

The decline in the manufacture of gasohol in this time of lower energy prices further aggravated the drop in farm land values. Many attribute the decline in farm land values to the passage of Initiative 300. Approved by voters in 1981, the initiative bans non-family farm corporations from acquiring farm land. Opponents believe the initiative has decreased the total demand for land, especially from corporate interests. Moreover, opponents maintain that agricultural processing facilities, the link between the grower and the market, have located outside the state because of this legislation. Hard evidence to support this view has yet to be demonstrated.

Some bankers also felt the need to support friends and neighbors beyond what was financially prudent, basing lending decisions on past commodity price trends and land valuations rather

TABLE 1
Location and 1980 Population of
Nebraska Banks Closed Since July 8, 1983

Bank of Niobrara, Niobrara	419
Bank of Blair, Blair	6418
David City Bank, David City	2514
Bank of Verdigre & Trust Co., Verdigre	617
Bank of Cody, Cody	177
Farmers State Bank, Kilgore	76
Uehling State Bank, Uehling	273
State Bank of Dannebrog, Dannebrog	356
Citizens State Bank, Arapahoe	1107
State Bank of Alexandria, Alexandria	255
Bank of Taylor, Taylor	278
Security State Bank, Edgar	705
Scroggins & Company Bank, Oak	79
Fairfield State Bank, Fairfield	543
Farmers State Bank of Rising City, Rising City	392
Elba State Bank, Elba	218
State Security Bank, Broken Bow	3979
Bank of Panama, Panama	160
Farmers State Bank, Sargent	828
Farmers & Merchants Bank, Comstock	168
Johnson County Bank of Tecumseh, Tecumseh	1926
First National Bank of Tekamah, Tekamah	1886

Source: Federal Reserve Bank of Kansas City and other sources.

than future cash flow potential. In addition, many chain banks are controlled by one owner or family with a subservient board unable to exercise significant control.[9]

Some banks failed for ancillary reasons. The closure of the State Bank of Dannebrog on January 7, 1985 was precipitated by the expiration of the liability bond on officers and employees without a replacement bond or the sale of the bank. State law forbids the operation of a bank without the liability bond. Roger Beverage stated that it took a technical declaration of insolvency to close the bank, but that its capital position was pretty good. The loss of the liability bond was caused by some unusual business practices wherein some of the bank's customers were participating with the bank in loans, mostly agricultural, to other customers, a practice that is in itself apparently legal. A blanket bankers' bond is intended to insure the institution against such things as dishonesty by officers or employees, burglary, or loss of cash in transit.[10]

Another financial institution, the Uehling State Bank, was closed on December 19, 1984 amid criminal charges against three formers owners involving $64,000 in alleged insider loans and forged promissory notes.[11] These insider loans exceeded the $10,000 legal loan limit. After an investigation, it was found that little money had been removed from the bank; rather, funds were moved within the bank to deceive bank auditors about the bank's financial soundness.[12] In this case, the Nebraska Banking Department exercised a new option provided by the 1984 Legislature (precipitated by the Commonwealth Savings Co. collapse) that authorized the state banking director to take certain actions if the banking director believes conduct by the banker may jeopardize the financial institution. Alternatives that can be pursued by the state banking director include a cease-and-desist order, fines, revocation of the licenses of banking officers, or a shutdown of the institution.

The State of Nebraska had $500,000 on deposit at both the Uehling and Dannebrog banks. The state lost $400,000 in each failure, the difference between its deposit and the FDIC reimbursement limit of $100,000 per account. The State of Nebraska had been depositing temporarily idle state funds in Nebraska banks and thrift institutions in accordance with a 1978 investment law, the purpose of which was to invest Nebraska monies within the state banking system, so the banks could make the money available to Nebraska borrowers.[13] Many other states have similar legislation. In early 1985, state deposits in excess of $100,000 were reported at 211 banks and 16 savings and loans. With the loss of $800,000 and the shortfall in state revenues reported in 1985, the efficacy of placing state funds in any bank indiscriminately has been called into doubt.

A financial institution, however, actually fails when it runs out of cash.[14] This precarious situation can be detected by means of several financial ratios, including the percentage of the loan portfolio classified as non-performing, non-performing loans as a percentage of capital, the ratio of equity to assets (which measures capital strength, or its safety reserves, calculated by dividing stockholders' equity by total assets on the balance sheet). Other key bank financial ratios include the liquidity ratio (derived by dividing the bank's liquid assets by its deposits) and the profitability ratio (which is net income divided by total assets).

The Nebraska State Department of Banking uses the CAMEL system to identify problem banks. CAMEL is an acronym for the following: Capital, Assets, Management, Earnings, and Liquidity. A number 1 rating is the best, and a number 5 rating is the worst. Problem banks are rated CAMEL 3-5. Over 65 percent of the state commercial banks are CAMEL 1 and 2. According to Roger Beverage, management is the most important measurement, because the inability of management to deal with problems causes bank failures.[15]

The failure of these twenty-two Nebraska banks and their timing can be traced directly to the high farm net income during the 1970s and the steadily increasing farm exports from 1977 to 1981. These increases encouraged an optimistic expansionist view that encouraged farmers to expand their acreage and convert marginal land to crops with center pivot irrigation systems. Young farmers, without the fears and conservatism instilled by the Great Depression, had too little equity and ran up enormous debts. As interest rates soared in 1979, interest costs on loans ate a growing share of the profits. The crushing blow was the drop in agriculture exports after 1981 caused by the Soviet grain embargo in 1980, the high value of the dollar, and increased competition from foreign countries such as Canada, Australia, and the nations of western Europe in providing grain exports.

The year 1981 marked a peak in agricultural exports and in total net income of Nebraska banks. Since then, both have dropped at an accelerating rate. It took about two to three years for these adverse economic factors to affect Nebraska banks. With two exceptions, there were no Nebraska bank failures until the David City Bank was closed on August 30, 1984. In the six

months after that failure, however, five banks failed. State banking officials did not become alarmed until the autumn of 1984, when they had the impression the bottom was falling out of land prices and farm machinery values.[16]

Nebraska bank failures are concentrated somewhat in an area between Broken Bow and Taylor, where much of the land has marginal agricultural value. It may be more likely to go out of production before this crisis passes than land in Iowa and Illinois.

Another factor in the geographic concentration of bank failures in certain areas is the lack of alternative employment, which prevents marginal farmers from seeking off farm income to make ends meet. At the same time, those farmers who must sell leave those areas because of the lack of alternative opportunities.

The lack of proximity to major markets drives up transportation costs, as well as depressing land values. For example, New England farmers, who are prospering in comparison to their counterparts in the Midwest, have benefitted from the general appreciation in New England real estate and their ability to diversify into other specialty products. At the same time, their proximity to major, densely populated markets enables them to sell directly to the consumer. Isolated Nebraska farmers have fewer bidders for their produce and are at the mercy of exports and selected buyers who can dictate price terms.

A two tier farm land market has developed. In areas of marginal land, prices are still falling, presaging further bankruptcies and bank closings in selected geographic regions. In the upper tier of highly productive acreage, land values may have bottomed out, although they may not have. As farmers and ranchers have defaulted on their loans, lenders have assumed control of collateral, usually in the form of land holdings; Nebraska lenders own about 140 farms and ranches containing over 140,000 acres. The fact that Nebraska and Iowa banks are required to dispose of farm land within five years[17] could add further downward pressure on farm land values if lenders are forced to dispose of these holdings quickly to meet time constraints.

THE PAST

An historical overview of Nebraska banking, such as that of W.E. Kuhn, illustrates several noteworthy points:

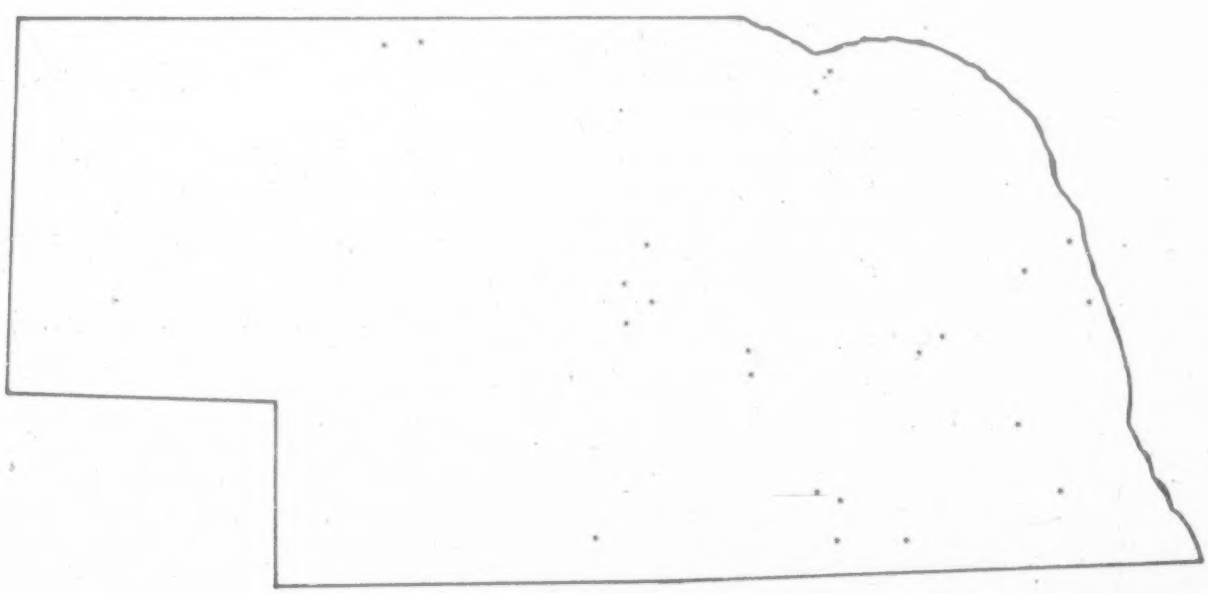
1. The banking system evolved on a trial and error basis as wildcat banks, saturation, and panic-produced failures led to legislation and regulation. For example, the Nebraska territory's whole financial structure collapsed with the banks in the panic of 1857.[18] The panic of 1893 and the ensuing depression claimed about 185 state banks and about 35 national banks. Bank deposits sagged from $35 million in 1892 to about $27 million in 1896. These losses led to the Deposit Guaranty Legislation Act of 1909 in order to provide depositor safety. As a result of this safeguard, the number of state banks and their deposits increased greatly until 1920,[19] creating a glut in Nebraska banking in the early postwar period. During the 1920s, an average of three national banks and thirty-five state banks failed each year in Nebraska.

These failures can be blamed on certain unsound business practices in land speculation, liberal loan policies necessitated by exorbitant interest paid on deposits, and on the inability and unwillingness of the State Department of Banking to refuse charters, thereby creating hundreds of banks for which there was no economic use.

These failures, considerably worse than the present crisis, led to the creation of an independent State Department of Banking in 1933 which was removed from political control and from the insurance industry. At the same time, the FDIC began operation on January 1, 1934, providing enhanced power to benefit bank creditors through greater supervisory powers and the backing of the U.S. Department of Justice. Federal deposit insurance was probably the key to stabilization of the banking system.[20]

2. The default of the Guaranty Fund in 1928 presaged by 55 years the default of the Nebraska Guaranty Fund for state chartered financial institutions following the Commonwealth Savings collapse. The Nebraska Guaranty Fund was created in 1976 for

FIGURE 1
Location of Nebraska Bank Failures Since July 8, 1983



the purpose of guaranteeing deposits in member credit unions and cooperative credit associations only. In 1977, the Legislature expanded the coverage to include industrial loan and investment companies. In both cases, the funds were established for the purpose of covering a select number of financial institutions, but became overextended and eventually collapsed as a result of the proliferation of institutions covered or the extension of coverage to institutions not originally eligible for coverage.

3. The post World War II emphasis on income derived from loans, as opposed to income derived from investment, and the added interest paid on deposits (all products of the increased credit demands of agriculture) set the stage for much of the present day money crunch felt by rural agricultural banks.

The 1970s were marked by two developments of importance to Nebraska banking:

1. The issue of commercial bank expansion through branching and bank holding companies still is being debated in the State Legislature and between rural and metro banking interests.

2. Electronic banking raised antitrust questions nationally as well as debate concerning the sharing of remote terminals by multiple numbers of banks and whether savings and loans could be excluded from the sharing agreement. The Nebraska Electronic Transfer System (NETS), established to share costs and terminal services, excluded savings and loans because savings and loans traditionally had been allowed to pay higher interest on savings. The NETS system allowed customers of many banks statewide to make transactions from the same terminal, with a central computer in Omaha coordinating respective banks.

The overriding issue in both of these developments is the efficacy of allowing urban-centered financial institutions to expand their domain of influence and services into rural regions and the state as a whole. The period from 1973 to the present has seen Nebraska, as many states, evolve from a unit banking and chain banking state to a state allowing both limited branching and multibank holding companies. This evolution spawned much debate, pitting large metropolitan banks against small rural banks.

As in earlier times, some permissive regulations, such as chain banking, were promoted by powerful political and social interests, while other interests opposed branching and holding companies, even though much of the difference between chains and holding companies is psychological.[21] As such, Nebraska has had potential statewide banking all along, but in a disguised form. At the same time, one bank holding company, Northwest Corporation, operated five banks in Nebraska through a grandfather clause, thereby granting them a legal competitive advantage. Moreover, the State Legislature has been circumvented on the issue of branching in part by the emergence of electronic banking, which extends unit banking beyond legal boundaries. This electronic banking favors large city banks who can afford the higher fixed costs of automatic teller machines and their enclosures and the expenses of overhauling their accounting systems to accommodate electronic banking.

By 1983, on the eve of the present banking crisis, the state banking system had legalized and set a structure that included unlimited chain banking, extended unit banking through electronic facilities, liberalized branch banking, and multibank holding companies such as FirsTier. This organization came about as a result of necessity and pragmatism, political pressure, and the realization that some form of extended statewide banking already had evolved outside the regulatory authority.

THE FUTURE

With farm surpluses increasing at an alarming rate, the export market declining, and net income down from 1981, the number of farms is expected to shrink to about 1.25 million units nationally by 2000 from the 2.24 million units assessed in the 1982 agricultural census.[22] The U.S. farm population has dropped from 30.5 million in 1940 to 5.8 million in 1984 and could decline by almost one-half by 2000. At the same time, net farm income is expected to decline 18 percent by 1989, with excess farm capacity remaining high.

These factors have led to a dramatic increase in the number of agricultural banks on the FDIC's list of problem commercial banks (437 at present versus 146 two years earlier). The percentage of banks on the problem list that are agriculturally based is 39.8 percent versus 24.2 percent in 1983.[23] Veribanc, Inc., a consulting firm based in Woburn, Massachusetts, found that farm banks made up 80 percent of the nation's 339 banks with more money in problem loans than capital.[24] The oil price decline since November 1985 may alter the composition of banks on the problem list. With Nebraska averaging about 9 percent of the total number of bank failures nationally, it is likely that the state probably has a considerable number of commercial banks on the problem list.

The president of Hawkeye Bancorporation of Iowa said that as many as one-third of Iowa's 634 commercial banks may not be around when the crisis ends. Some will merge with others, and some will fail.[25] With about 457 commercial banks in Nebraska, banks could decline by more than 100 over the next few years. Add to this the fact that the FDIC chairman predicted recently that as many commercial banks probably will fail nationally in 1986 as the 120 that failed in 1985. These failures will strike hard in agricultural areas and energy producing regions.

The consolidation and merger of small farms and small banks are inevitable in light of the increased costs incurred by higher interest paid to attract deposits, the costs of electronic banking, general inflation, and the depressed unit selling price of services as a result of the farm economy.

The farm crisis of the 1980s may have shifted the balance of power in favor of large metropolitan banks. The state admitted the necessity of more liberalized branching and bank holding companies in legislation of March 1984 which allowed a healthy financial institution to take over a troubled one without being penalized by some statutory limitations on banking properties. The purchased bank also would not count as one of the nine institutions a bank holding company can operate. This may or may not aid Nebraska's economy.

The emergence of expanded branch banking and bank holding companies is inevitable as banks seek to diversify from a single economy. At the same time, regional interstate banking has been declared legal in a U.S. Supreme Court decision of June 1985, thereby setting the stage for regional banking throughout the country.

The key to interstate banking is reciprocity, wherein a financial institution in Nebraska can expand into those states whose

banks are authorized to move into Nebraska. Another development is the emergence of limited service facilities such as Citicorp in Omaha that offer either checking accounts or commercial loans, but not both. The U.S. Supreme Court, in effect, legalized such institutions by declaring that they do not fit the description of a bank.

In the long run, the larger metropolitan banks will carry the small town banks, offering expanded services and more competition. Unfortunately, outside bank managers may be more insensitive to local needs, seeing local townspersons as faceless statistics on a balance sheet. This presages a sombre future for many small Nebraska towns who can only hope for a decline in interest rates, an increase in exports and commodity prices (that are beyond their control), and the diversification of the economy toward new outside industry.

In the final analysis, the solution to the misfortunes of many small towns in Nebraska hinges on two factors. First, the very decline in land values will make it attractive for some enterprising individuals to enter farming because as entry costs decrease, return on investment will increase (given a steady net income).

Second, with the liquidity problems of small town banks, the income consciousness of larger bank holding companies, and the budget cutting temper of the federal government, the ability to attract new industry to communities as a means of diversifying the economy and providing jobs can be found only in capital availability programs and small business support systems, which are the primary means of providing an economic climate conducive for business and industry to locate and remain in the area. Yet, Nebraska has fared poorly in studies analyzing its business climate, such as in *Inc.* magazine.[26] Hence, a good business climate must be fostered to attract capital to finance enterprise that builds the deposits necessary to rejuvenate banking.

LOUIS E. JEFFRIES

Endnotes

1. *Omaha World-Herald*, Sunday, March 9, 1986, p. 1.
2. *Ibid.*, Sunday, December 29, 1985, p. 1.
3. *Ibid.*, Friday, December 6, 1985, p. 12.
4. *Lincoln Journal-Star*, Sunday, August 4, 1985, p. 6A.
5. *Omaha World-Herald*, Thursday, September 19, 1985, p. 15.
6. For a complete explanation of the different banking structures, see Lynn Nejezchleb, "The Recurring Debate on Nebraska's Banking Structure," *Business in Nebraska* (August 1982), pp. 1-6.
7. *Omaha World-Herald*, Thursday, September 20, 1984, p. 1.
8. *Lincoln Journal-Star*, Sunday, August 4, 1985, p. 1A.
9. *Ibid.*, Sunday, August 4, 1985, p. 1A.
10. *Lincoln Journal*, Monday, January 7, 1985, p. 1.
11. *Omaha World-Herald*, Friday, January 4, 1985, p. 1.
12. *Ibid.*, Tuesday, August 13, 1985, p. 1.
13. *Ibid.*, Friday, December 21, 1984, p. 1.
14. *Lincoln Star*, Monday, September 24, 1984, p. 5.
15. *Omaha World-Herald*, Saturday, October 19, 1985, p. 11.
16. *Lincoln Journal-Star*, Sunday, August 4, 1985, p. 6A.
17. *Omaha World-Herald*, Sunday, February 23, 1986, p. 1-A.
18. W.E. Kuhn, "History of Nebraska Banking: A Centennial Retrospect," *Business Research Bulletin*, Number 72 (April 1968), p. 6.
19. *Ibid.*, p. 14.
20. *Ibid.*, p. 24.
21. *Omaha World-Herald*, January 4, 1976, p. 9-C.
22. *Lincoln Star*, Tuesday, March 18, 1986, p. 1.
23. *Omaha World-Herald*, Sunday, March 23, 1986, p. 1-M.
24. *Ibid.*, Wednesday, January 29, 1986, p. 9.
25. *Lincoln Journal*, Thursday, December 5, 1985, p. 1.
26. Nell Margolis, "Inc.'s Fifth Annual Report on the States," *Inc.* (October 1985), pp. 90-93.

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NEBRASKA BANKS' DEPOSIT RECORDS

Nebraska banks' deposit records--both state and federally chartered institutions--for December 31, 1984 and December 31, 1985 are available from the Bureau of Business Research. This publication lists EACH Nebraska bank, its deposits, and the percentage change in deposits from December 31, 1984 through December 31, 1985. Banks are listed alphabetically by community for easy reference. NOTE: ONLY NEBRASKA BANKS ARE INCLUDED. . .SAVINGS AND LOANS ASSOCIATIONS ARE NOT COVERED IN THIS PUBLICATION.

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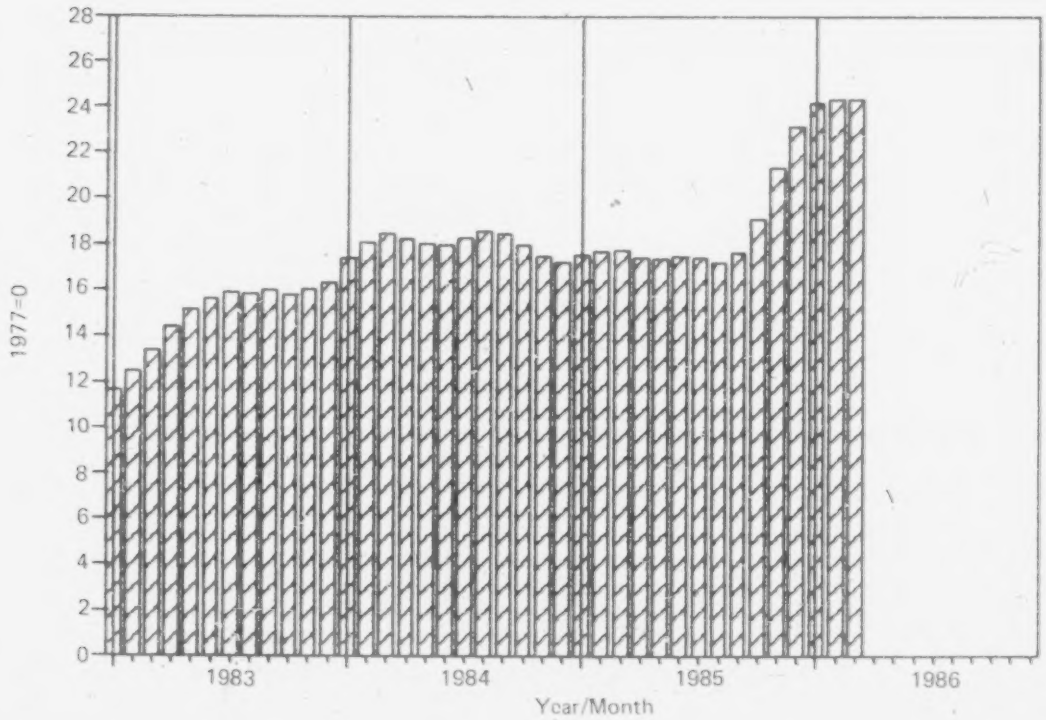
Chart 1
Nebraska Composite Leading Index



As depicted above, the Nebraska composite index of leading economic indicators registered a minute gain during March of the current year. The sizable gains in the leading index from October 1985 through January 1986 tapered in February, with an increase of 0.10 percent.

The slowdown in the Nebraska leading index is due mainly to an increase in adjusted initial claims for unemployment insurance and a decline in construction activity. It should be noted again that the claims and construction components are smoothed before inclusion in the composite index. The stock price component continued a pattern of upward movement, while average weekly earnings in manufacturing remained virtually unchanged. The March index for prices received by Nebraska farmers again recorded a decline, albeit the smallest in the last four m[illegible] Data available for April indicate probable upward move[illegible] the leading index for that month.

Increases in the Nebraska leading index during the latter half of 1985 indicated the likelihood of economic improvement for the state during the first half of 1986. Improvements in the employment picture during March and April lend some credence to this optimistic outlook.

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